Office of Chief Counsel
Internal Revenue Service

memorandum

CC:[redacted]:TL-N-2869-98
[redacted]

date: DEC 27 1999

to: Chief, Examination Division, [redacted]
[redacted], Revenue Agent, [redacted]
[redacted], Revenue Agent, [redacted]
[redacted], Engineer, [redacted]

from: District Counsel, [redacted]

subject: **Valuation of Stock in Exchange for Debt Securities**
[redacted]
Years: [redacted]

We have received your request for advice regarding the improper accounting practices of [redacted], the predecessor corporation of [redacted], and their effect on the value of stock at the time the corporation issued stock to its shareholders to retire debt.

Issues

Whether [redacted] received cancellation of indebtedness income under I.R.C. § 108(e)(8) when it issued overvalued stock to its shareholders in exchange for debt.

Whether [redacted] is required to recognize any income in connection with the [redacted] issuance of its debentures?

Conclusion

[redacted] did not receive cancellation of indebtedness income when it issued stock to retire its debt. Although the improper accounting practices of [redacted] caused its stock to be overvalued, the fair market value of the stock at the time [redacted] exchanged it for debt was the price listed on the American Stock Exchange. Subsequent events revealing the corporate stock was overvalued did not effect the value of the stock at the time of the exchange. Upon redemption of the debentures for stock, the face value of the debentures was less than the stock price resulting in no discharge of indebtedness income. Under no other theory would the corporation have received income from exchanging stock for debt.

However, [redacted] may have received income at the time it borrowed the money from its bondholders if, at the time [redacted], received the money it had no intention to make repayment.

Facts

[redacted] was a corporation dealing in [redacted]. Its stock was publicly traded on the American Stock Exchange. On [redacted], it issued $[redacted] dollars of debentures which were initially convertible into common stock at $[redacted]/share. After the debentures were issued, [redacted] stock split and the convertible price became $[redacted]/share. On [redacted], when [redacted] stock was valued at $[redacted] share, the corporation announced its intention to redeem the debentures that it had issued on [redacted]. Because the face value of the debentures was less than the price of the stock, all holders redeemed their debentures for stock.

On [redacted], the corporate officers publicly announced that their accounting policies were not in line with the Generally Acceptable Accounting Principles (GAAP). [redacted] failure to conform to GAAP resulted in total net earnings being overstated by $[redacted] during the years [redacted] through [redacted]. When [redacted] changed their accounting practices to adhere to GAAP, it wrote off $[redacted] in accumulated earnings. On [redacted], the day after its announcement, [redacted] stock fell from $[redacted] share to $[redacted] share.

The shareholders filed a class action suit against [redacted]. In addition, the Securities and Exchange Commission (SEC) filed a complaint in federal district court against the corporation alleging that it violated the antifraud provisions of the Securities Act and the antifraud, reporting, internal controls and record keeping provisions of the Exchange Act by issuing false and misleading earnings announcements from [redacted] through [redacted], along with false and misleading financial statements and registration statements filed from [redacted] through [redacted]. As a result of these court actions, [redacted] had to pay in excess of $[redacted] to its shareholders and $[redacted] to the SEC to settle its suits.

The examining agent proposes to revalue the stock as of the date of the redemption from $[redacted] share to $[redacted] share to accurately reflect the stock's value. By doing so, the corporation would have only been able to redeem bonds worth $[redacted] instead of $[redacted] dollars and would have received $[redacted] dollars of discharge of indebtedness income.[1]

Legal Analysis

Discharge of Indebtedness

I.R.C. § 1032(a) provides for the nonrecognition of gain or loss by a corporation receiving "money or other property in exchange for stock (including treasury stock)."

If a corporation issues stock in exchange for debt securities, it receives income from discharge of indebtedness to the extent of the difference between the fair market value of the stock and the issue price of the debt. See I.R.C. § 108(e)(8), formerly, I.R.C. § 108(e)(10)[2].

When [redacted] issued stock to retire its outstanding debt, it did not realize discharge of indebtedness income. The fair market value on the date of the redemption equaled the issue price of the debt. Because the corporate stock was publicly traded on the American Stock Exchange, the fair market value of the stock was easily determined. The examining agent's proposal to revalue the stock on the date of the redemptions based on inflated earnings of the corporation and securities law violations is totally unsupported by any legal authority under the case law, the Internal Revenue Code or the treasury regulations.

In a similar case, taxpayers exercised employee stock

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[1] This adjustment only reflects the amount of income due to discharge of indebtedness for the year ending December 31, [redacted]. [redacted] also redeemed convertible bonds of $[redacted] dollars in [redacted] and $[redacted] dollars in [redacted]. In revaluing the stock to reflect a stock price of [redacted]share for those redemptions, the examining agent determined the taxpayer would have received discharge of indebtedness income for the years ending December 31, [redacted] and December 31, [redacted], in the amounts of $[redacted] dollars and $[redacted] dollars, respectively. Accordingly, if the stock was revalued, the total adjustment would be $[redacted] dollars.

[2] Under former § 108(e)(10)(repealed in 1993), if a debtor corporation was in bankruptcy, any income from discharge of indebtedness would be excluded and the corporation would not have to reduce its tax attributes. If a debtor corporation was insolvent, it could exclude income from discharge of indebtedness to the extent of its insolvency.

options and argued that the stock's fair market value on the date they exercised the option was not the trading price listed on the New York Stock Exchange. They argued the price of the stock should have been lower due to violations of securities laws which inflated the exchange price. The Ninth Circuit Court of Appeals held that where an active and unrestricted market for the stock existed, undisclosed securities law violations did not affect the price the taxpayers could have obtained for their stock on the dates they exercised their options. Johnson v. Commissioner, 673 F.2d 262, 266 (9th Cir. 1982). See also Horwith v. Commissioner, 71 T.C. 932, 939 (1979). Accordingly, the court determined that the fair market value was the mean price per share listed on the New York Stock Exchange. Although the court noted that there are limited exceptions in cases where an open market does not exist, the stock exchange price is generally the best indicator of fair market value. Johnson, 673 F.2d at 265 (citing United States v. Cartwright, 411 U.S. 546, 551 (1973)).

Even though [redacted] stock was inflated on the date of the redemptions, there is no statutory, judicial or regulatory support for revaluing its stock due to undisclosed securities violations.[3] Because the price of the stock equaled the issue price of the debt on the date of the redemptions, [redacted] did not receive income from discharge of indebtedness income.

§ 61 Income

A "swindle," that is, obtaining money through some false pretense or devise, is taxable income to the swindler.[4] Moore v. United States, 412 F.2d 974 (5th Cir. 1969). In Moore, the Fifth Circuit examined a swindle by Billy Sol Estes, who had created a debtor-creditor relationships with farmers and sold their loan agreements to finance companies. Despite loan agreements, the Court found that he realized income from his scheme to factor promissory notes to the finance company even though he made regular payments and may have intended one day to reimburse the finance companies.

Generally, the proceeds from a bona fide loan do not constitute income because whatever temporary economic benefit the borrower derives from the use of the funds is offset by the corresponding obligation to repay them. Whether a transaction is

[3] As a practical matter, any other rule would make valuation very difficult.

[4] To the extent the victim recovers the swindled finds, the swindler reduces its income for the tax year of the recovery.

a loan for income tax purposes is a factual question.

The most important factor distinguishing a loan from a taxable "swindle" is the intention of the parties that the money advanced be repaid. The SEC documents may shed light on the intention of the taxpayer.

Another faction to consider is whether the recipient of the funds has any restrictions over their disposition. The debenture should reveal any restrictions.

The fact that, in form, this was a loan does not make any difference for tax purposes. United States v. Rochelle, 384 F.2d 748, 751 (5th Cir. 1967) (Where the loans are obtained by fraud, and where it is apparent that the recipient recognizes no obligation to repay, the transaction becomes a wrongful appropriation and comes within the broad scope of gross income).

The courts look at how the money was used. In my opinion this is an important factor in this case. Were the proceeds of the loans used for corporate purposes? Or, were the proceeds used by the corporate officers for non-business purposes? In In re Diversified Brokers Company, Inc., 487 F.2d 355 (8th Cir. 1973), the court found that the corporation had been a simple conduit, with no control over the disposition of the funds and no cognizable benefit gained. The corporate officers had embezzled the funds from the corporation--thus the tax liability was that of the corporate officers, not the corporation.

I suggest that you find out, if you do not already know, (i) how much was repaid to the debenture holders and (ii) whether sufficient funds were available to repay the debenture holders. These facts are relevant in distinguishing Diversified Brokers from the facts in this case.

If the facts tend to show that [redacted] did not intend to repay the debenture holders, had insufficient funds to do so, used the money for corporate purposes, and had no restrictions on access to the funds, we suggest a determination that [redacted] realized income under I.R.C. § 61 when it borrowed the money.

If you have any questions, please contact [redacted] at [redacted].

By: [redacted]
Attorney